A Customer Perception of an FMS Issue: Proposed DFARS Amendment to Permit Customers to Observe Price Negotiations

By

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[*Deputy Secretary of Defense John J. Hamre's memorandum to the Secretaries of the Military Departments on March 23, 1999 set in motion significant changes in the customer participation in Foreign Military Sales (FMS) contract preparation and negotiations. In the memorandum, FMS customers are encouraged to "participate" in the discussions between DoD and the potential contractor. The FMS customer may ask to observe price negotiations provided the contracting officer obtains permission from the potential contractor and obtains assurances from the FMS customer that no negotiations will be conducted except by the government contracting officer. The consent from the offeror shall be in writing and shall specify any restrictions on the disclosure of proprietary data by the FMS customer. The FMS customer should provide any written assurance of non-disclosure that the potential contractor requires. Dr. Hamre's memorandum was the impetus for the proposed revision of Defense Federal Acquisition Regulation Supplement (DFARS) 225.7304 "to specify that, if requested by FMS customer, the contracting officer should permit the FMS customer to 'observe' contract price negotiation and should provide the FMS customer with information regarding price reasonableness". The following article addresses the perception of the effect of Dr. Hamre's memorandum and the proposed DFARS revision on the FMS customer*.]

In the recently published DSCA's Strategic Planning Process and Benefits (the "Plan"), the DSCA maps a high level view of how it plans to respond, among other things, to customer requests for change in the FMS process. General Davison and his staff, by completing the Plan, set for themselves and the security assistance community a challenging task: the U.S. government, its customers, and the defense contractors must now make good on the Plan. Each contributed to it, and each is responsible for cooperating to propel the FMS process towards the identified goals, notwithstanding the inevitable friction over the best path towards those goals. It needs to be remembered that while in physics "light makes heat", in cooperative, multi-stakeholder efforts the opposite is often true, i.e., "heat makes light". In that spirit, and in pursuit of Strategy C-2-1 (5) of the Plan that calls for gathering "customer feedback on a regular basis", perspectives are offered here on a current initiative, the proposed amendment to DFARS that would modify the blanket prohibition on customer attendance at price negotiations.

The views offered are those of a legal counsel who regularly briefs, advises, and represents ministries of defense and their defense procurement agencies. The views reflect discussion of these issues with such personnel and their ministry in-house legal advisers. However, no particular government's view is expressed here or disclosed in any way, and thus the views expressed should be attributed solely to the writer.

The proposed amendment to DFARS for "Foreign Customer Observation of Negotiations"[1] appeared on April 28, 1999 in the Federal Register[2] allowing interested parties to comment on it until June 28, 1999. Foreign military are sometimes confused by the format of published amendments because the proposed rule is described in three successive, often inconsistent, versions: version one—a brief summary, version two—background and a general description, and version three—the actual text. Foreign military officers and officials, sometimes in haste and under tremendous time pressures, read the first and second version, and mistakenly assume the actual text will match it and not read through the detailed text. They have expressed considerable surprise on hearing what the actual text of the proposed amendment says, the risks it creates, and the apparently unintended consequences it would have.

The proposed DFARS amendment responds to a persistent complaint of FMS customers: they want to participate in the price negotiations between the U.S. government and the U.S. defense contractor. From a customer's perspective, the reluctance to allow them to participate is commercially paradoxical: why shouldn't the buyer—the one putting up the money—be allowed to participate in the price negotiations? Why shouldn't the buyer receive more than an opaque summary of price in the P&A rather than a break out of costs line-by-line as would occur in most commercial transactions? As the *IEEE Spectrum* journal noted back in November 1988, "Though military procurement is often portrayed as just another big business, it really exists in an insular world where the rules are necessarily different from those of the free market."[3] However, many of the DoD reforms of this decade have been characterized in terms of introducing commercial practices into defense procurements.

In light of such goals, the FMS customers' requests to participate in price negotiation appear to have been high on the list of changes contemplated by the DSCA's Plan, since the proposed DFARS amendment is one of the first concrete actions to emerge from the past year's "re-engineering" of FMS and the resulting DSCA's Plan. Deputy Secretary of Defense Hamre's memorandum, dated March 28, 1999, which issued "guidance for FMS customer participation in the preparation and negotiation of their contracts", signaled the proposed DFARS amendment.[4] Notice Deputy Secretary Hamre's choice of the key words: "participation" in the "negotiation" of contracts. The meaning of "participate", however, is different than what many customers sought. As Deputy Secretary Hamre further explained, "there will be no negotiations other than by the contracting officer." The memorandum concludes with the instruction that the "Director of Defense Procurement shall amend DFARS 225.7304 to establish procedures authorizing representatives of FMS customers to observe price negotiations." Thus, "participate" means only to "observe".

How did FMS customers perceive that announced initiative? Some hoped it would give them insight into the awarding and negotiating of contracts from which they might learn when they elect to negotiate directly with contractors in direct commercial contracts. Others hoped that by "observing" the course of long negotiations the customer would gradually shift into a deeper "participation" in the negotiations—and exert an influence on them, if not conduct moments of them. DoD drafters anticipated such hopes and went to considerable lengths to preclude that from happening.

Unfortunately, the DoD drafters went too far, and, in the current version of the proposed DFARS amendment, created risks for the customer, risks that exceed the potential benefits. The DoD drafters also did not go far enough to avoid giving FMS customers the impression that the proposed rule offers them little of what they sought in FMS change.

First, the opportunity to "observe" negotiation can be vetoed by the contractor. Before the customer can be allowed to observe, the contracting officer must receive from the contractor "written permission consenting to the observation of price negotiations by the FMS customer." Customers have expressed the view that by giving the contractors such veto power, the FMS process would be little improved by the proposed DFARS amendment.[5]

Second, the contractor's written consent "must include any restrictions on the disclosure of proprietary or other data." Customers cannot reasonably complain about this, and actually benefit from it. Since contractors will regard their pricing information as "proprietary" they must, under the U.S. trade secret laws, protect such information by identifying it and marking it as "proprietary". The commercial equivalent of this requirement is a non-disclosure agreement. Curiously, the proposed DFARS amendment does not propose that, nor offer a standard clause that would cover negotiations of price. The proposed DFARS, in this respect, disserves the contractor: while a contractor could reasonably put restrictions on disclosure of "proprietary" data, it is unclear what is meant by "other data" unless what is meant is "confidential" information. Since "confidential" was not used in the text, the proposed DFARS amendment would appear to give a contractor the right to restrict disclosures of what was not "proprietary" nor "confidential", but just something they decided to preclude the customer from disclosing. Such vagueness and expansiveness would invite abuses: some contractors might restrict disclosure of the same kind of non-confidential, non-proprietary information as would be disclosed to the customer in negotiations on aspects other than price. In short, this aspect of the proposed DFARS amendment gives the contractors power over customers that did not previously exist and to which many customers will not want to be subjugated.

Third, the proposed DFARS amendment requires that the customer certify in "written assurances" that it will not:

(a) Disclose any proprietary or other contractor data except as specifically authorized by the contractor;

(b) Discuss with the contractor any issue related to the negotiation of price either during or separate from negotiations.

The first clause is perplexing. It could have required customer assurances that the customer would not disclose what the contractor's written consent identified as prohibited from disclosure. That would have been parallel, and made it possible for contractor and customer to know their respective positions. Instead, while the contractor's writing must identify restrictions on "disclosures of proprietary or other data", the customer's writing must provide that the customer will disclose only "proprietary or other contractor data" specifically authorized by the contractor. The customers have asked how are we to know what we can disclose, when the contractor's writing only tells us what we cannot disclose? Where is a writing that "specifically authorizes" us and informs us about what we can disclose? There is no such writing required. By failing to make the contractor and customer requirements parallel, the proposed DFARS amendment creates a gap, one that puts the customer in the dark and at considerable risk of failing to abide by the DFARS provisions.

Clause (b), quoted above, creates the worst risks for the customer. Whatever may have been the intended meaning of the clause, it does not say what would have been reasonable to say: The customer shall not, during the price negotiations, discuss any price with the contractor; such

restriction shall cease upon the signing of the contract. Instead, Clause (b) prohibits the customer from discussing with the contractor virtually anything—"any issue related to the negotiation of price either during or separate from negotiations." Few contractual issues are utterly unrelated to price: performance, safety, testing, MTBF, MTTR, reporting, delivery schedule, warranties, and even disputes clauses can vary according to the price a contractor seeks to charge and a customer is willing to pay. As phrased, Clause (b) prohibits a customer from discussing with the contractor any crucial element of the bargain. That prohibition does not currently exist. Customers can discuss the bargain with contractors. There is no apparent justification for insisting that customers trade off their right to discuss the bargain in exchange for being a fly on the wall during the price negotiations.

Moreover, Clause (b) fails to identify the end of the period during which the customer cannot discuss "any issue related to price" with the contractor. As drafted, that prohibition remains in effect after the signing of the contract, and would be in effect at Preliminary Design Review, Critical Design Review, Acceptance Testing, and negotiations over those and other events that often tend to be milestones whose successful completion entitles the contractor to payment of a portion of the purchase price. By extending that period indefinitely, the proposed DFARS amendment would put the customer at risk of violating its assurances of non-disclosure and violating the DFARS. Such action could prompt the contractor to terminate the contract, take other legal action, or prompt the U.S. government to cancel the LOA. Since Clause (a) also does not suggest any end to its period of restrictions, the customer could indefinitely be at risk of violating federal and state trade secret laws, including the Economic Espionage Act of 1996, which carries criminal penalties of imprisonment and fines. Customer governments, if they understood the risks, would want to take the opportunity to "observe" negotiations in exchange for being exposed to such risks. Legal counsel to customer governments could not advise that such risks are prudent to take, or that the consequences that might result could be successfully controlled.

For those reasons, the proposed DFARS amendment, as drafted, appears to inadvertently depart from the objectives of the DSCA Plan and the instructions of Deputy Secretary Hamre's March 28, 1999 memorandum. One of the advantages of proposing rules for comment is to provide an opportunity for drafters to receive comment from those who have a different perspective. The initiative represented by the proposed DFARS amendment is in reply to customer complaints, though many customers would say that mute observer status is far from the participation they requested. Since U.S. law does not entitle the U.S. government to compel a contractor to disclose proprietary data to customer governments, it is necessary for the proposed DFARS amendment to be predicated on contractor consent for the customers to participate. However, it is quite unclear to some customers why, with that veto power, a contractor could not also be given the power to consent to let the customer participate in the negotiation discussion, provided that they were not given the final say on what was and was not to be agreed to—a responsibility that must remain with the contracting officer—and provided that they were clearly informed that if their participation caused the negotiations to be prolonged they would be charged for that extra effort by both the U.S. government for its efforts and by the contractor for its efforts. Put that cost to a customer government, and the result will likely be that most customers will be deterred thereby from unreasonably participating in the negotiations. FMS customers should get what they bargained for, and not something else, and should pay for what they cause the bargain to include.

End Notes

1. Defense Federal Acquisition Regulation Supplement; *Foreign Military Sales Customer Observation of Negotiations*, [DFARS Case 99-D005], 48 CFR Part 225, April 28, 1999.

2. *Federal Register*, Vol. 64, No. 81, Wednesday, April 28, 1999, Proposed Rules, at 22825 - 22826.

3. Zorpette, Glenn, "Government Oversight," *IEEE Spectrum*, Vol. 25, No. 12, November 1988, p. 44.

4. Hamre, John J., *DoD Policy on Customer Participation in Foreign Military Sales (FMS) Contract Preparation and Negotiations*, published in the web-version of the DoD Deskbook at URL address: http://web.deskbook.osd.mil. The DoD and its various departments deserve considerable praise for creating a resource as useful as the Deskbook, and one that enables the FMS customer to substantially reduce research time and costs. It is a splendid website and FMS customers will find it is much more informative and easier to use than many websites maintained by customer ministries of defense. While "transparency" has become a vague and uninformative buzzword, the Deskbook was designed to inform and succeeds admirably.

5. The proposed amendment is silent on when the contractor would have to receive such written consent. It would be hard for customers to observe if they were not given much advance notice, especially if they have to assemble an informed team and bring them in from overseas. The rule also does not address issues such as customer requests to know before signing an LOA if the likely contractors have expressed an intention to sign and give consent for them to observe the negotiations. These issues will undoubtedly arise, and it may be prudent in the next version of the amendment to consider addressing them.

About the Author

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